

Statement of Barclays Global Investors

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Good afternoon, Mr. Chairman and members of the Committee. My name is Amy Schioldager and I am the Head of US Equity Indexing Products at Barclays Global Investors. In that role I am responsible for the management of our REITs index funds. I appreciate the opportunity to discuss with you the issues relating to adding a REIT index fund option to the Thrift Savings Plan. As a long-term provider of investment management services to the Thrift Savings Plan, BGI is pleased to offer our experience and expertise.

I'd like to begin with a brief overview of BGI and our relationship with the Thrift Savings Plan. I will then discuss the advantages of REITs as an asset class as well as BGI's experience managing REIT index funds. Finally, I'd like to discuss several of the key issues surrounding the addition of REITs to the Thrift Savings Plan.

Mr. Chairman, we at BGI are honored to have served as an investment manager for the TSP since 1988, and we take our responsibilities for the management of the retirement assets of the Federal workforce very seriously. We take great pride in the mandates that we have been awarded by the TSP to manage four of the plan's five investment options—each an index fund that tracks a widely followed stock or fixed income benchmark. It is important to note that we have successfully retained this relationship in regular, highly competitive bidding processes since the TSP's inception.

Participants in the Thrift Savings Plan can invest in five separate funds: the C Fund (based on large-capitalization US equities), the S Fund (based on mid- and small-capitalization US equities), the F Fund (based on the Lehman Aggregate Long-term Bond index), the I Fund (based on the MSCI Europe Australia Far East (EAFE) index of non-US equities) — as well as the G Fund, which invests in U.S. Treasury securities. From a pure investment perspective, introducing additional asset class options to the TSP could benefit participants by increasing the diversification of their menu of investment choices.

Allow us a few words about the context and history of REITs.

Institutional investors have long valued real estate as a critical element in their portfolios. Real estate generally has a low correlation to other asset classes, so it diversifies a portfolio that is invested primarily in stocks and bonds. Rental income can deliver strong

cash flows, and can provide a hedge against inflation. Obviously, for individual investors, however, investing in direct real estate requires a broad set of specialized skills—as well as a great deal of time—which is impractical for most investors.

The creation of Real Estate Investment Trusts (REITs) in 1960 introduced an easier way to invest in real estate especially for individual investors and small to mid-size defined benefit plans which lack the asset size to develop a well-diversified direct real estate portfolio. REITs are publicly traded companies that own and operate commercial real estate as their primary business. They offer a convenient way for investors to gain exposure to a diverse set of real estate holdings, across property types and geographic markets. REITs can be thought of as real estate stocks, and they are traded on the major stock exchanges. The REIT market grew dramatically in the 1990's and today there are approximately 160 publicly traded REITs in existence with a market capitalization of more than \$250 billion. They have become increasingly accepted as part of the retirement plan portfolio, with one out of eight defined contribution plans including REITs as an investment option and almost 4 percent of the assets in the largest 1,000 defined benefit plans invested in this category.

REITs offer to the investor the ability to gain exposure to real estate through an investment, which has, on average, sufficient liquidity to gain access to that asset class cost effectively. Furthermore, REITs have a low correlation to other asset classes. For example, the performance of REITs versus the S&P 500 Index since 1963 shows annual return differences greater than 20%—both positive and negative. Moreover, the correlation between REITs and equities actually declined during the 1990s, implying an increase in their diversification properties. This coincided with an increase in the number, breadth and size of the REIT sector as well as REITs becoming more diversified across property types and geographic markets.

As the members of this Committee are well aware, diversification is critically important in investing. By ensuring that a portfolio is not dependent on any one asset class for performance, diversification improves the potential for better returns over the long term. Thus, it is important to note that while REITs are publicly traded like stocks, they are a different asset class and their return pattern can behave quite differently from the broader US equity market. However, it's also worth noting that REITs represent 0.55% of the S&P 500 Index, the benchmark tracked by the C Fund, and 8.10% of the Dow Jones/Wilshire 4500 Index, the benchmark tracked by the S Fund. As a result, TSP participants investing in these two funds are already getting an exposure to REITs.

Mr. Chairman, BGI is the largest manager of tax-exempt REIT index funds in the world, with approximately \$10 billion of assets under management in US REITs. We have a long and deep experience managing investments in this asset class. In that light, there are a number of issues we would encourage the Committee to consider as they contemplate the inclusion of REITs in the TSP. Let me focus on two critical ones: costs and liquidity, two subjects we initially discussed in a letter, dated January 25, 2005, to Chairman Davis in response to his January 5 letter to us.

First, consider costs. A key question is: can a REIT option be offered to TSP participants at or near the same cost as the current investment options? There are two costs that need to be considered: investment management fees and transaction costs. With respect to management fees, there are many factors that potential providers would consider in developing a fee quote for such a product, including the complexity of managing the investment strategy and their assessment of the competitive landscape.

Obviously, we cannot comment on what other providers might bid for this business. What we can say is that management fees for institutional REIT index funds tend to be in the range of 10 to 15 basis points, while fees for REIT index mutual funds are in the 25 basis point range. Given the potential size of investment by TSP participants, we expect that management fees would be lower than these levels, but they might be modestly higher than the fees currently charged for some of the existing TSP investment options.

Transaction costs are an important consideration given the size of potential cash flows and the frequency with which many TSP participants trade. Depending on the size of the trade, and given current levels of market liquidity, we would estimate that total transaction costs (including commissions, bid/ask spread and market impact) could range from 26 basis points for a \$10 million trade to 59 basis points for a \$100 million trade. To show the comparative illiquidity of REITs, estimated transaction costs for a \$10 million trade in the C Fund benchmarked to the large capitalization S&P 500 Index would be approximately 7 basis points, while a \$100 million trade would be approximately 9 basis points.

A second important issue to consider is whether the REIT marketplace offers sufficient liquidity to absorb the potentially large daily market flows (in or out) generated by TSP participants. Our analysis of the REIT marketplace shows that most of the REIT indices have liquidity characteristics similar to the US small-capitalization equity market in which the TSP's current Dow Jones/Wilshire 4500 Index option, the S Fund, invests. We have worked with TSP staff to establish procedures that have cost-effectively managed cash flows in this market since this option was added to the plan in 2001. Assuming that one of the more liquid REIT indexes were selected as the benchmark for a potential new option, we believe that these same procedures would work just as effectively for a REIT index fund option.

Before concluding I'd like to make a further point. When considering additional options to the Thrift Savings Plan, there are many asset categories worthy of evaluation, and we encourage the Committee to take a broad view of candidate asset classes when determining if REITs are the most appropriate potential addition. There are indeed others worthy of consideration, such as emerging market equities and commodities. Before selecting a new investment option, it would be appropriate to analyze the full spectrum of asset class options available, to evaluate their diversification potential and return opportunities and then select the most suitable additional option(s).

Mr. Chairman, since its founding, BGI has been focused on a single global investment philosophy, which we call Total Performance Management. In brief, our objective is to

deliver superior investment results by efficiently capturing the returns of market indexes while rigorously controlling all risks and minimizing trading and other implementation costs. This simple, yet profound approach is rather unique in the industry, and helps us avoid investment “fads” or dependence on star managers or stock pickers.

We believe that philosophy has well served participants in the TSP and our other clients. And we also believe that those principles—managing risks and controlling costs while capturing the returns of an asset class—are the ones that should underscore the addition of any new investment options to the Thrift Savings Plan.

Mr. Chairman, I thank you for the opportunity to speak with you today and I look forward to answering any questions you may have.